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Islamic Microfinance: A Missing Component in Islamic Banking

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1. Introduction

Microfinance means "programme that extend small loans to very poor people for self employment projects that generate income in allowing them to take care of themselves and their families" (Microcredit Summit, 1997). The World Bank has recognized microfinance programme as an approach to address income inequalities and poverty. The microfinance scheme has been proven to be successful in many countries in addressing the problems of poverty. The World Bank has also declared 2005 as the year of microfinance with the aim to expand their poverty eradication campaign.

The main aim of the paper is to assess the potentials of Islamic financing schemes for micro financing purposes. The paper argues that Islamic finance has an important role for furthering socio-economic development of the poor and small (micro) entrepreneurs without charging interest (read: *riba'*). Furthermore, Islamic financing schemes have moral and ethical attributes that can effectively motivate micro entrepreneurs to thrive. The paper also argues that there is a nexus between Islamic banking and microfinance as many elements of microfinance could be considered consistent with the broader goals of Islamic banking. The paper, first, introduces the concepts of microfinance, and presents a case for Islamic microfinance to become one of the components of Islamic banking. The paper then discusses, the potentials of various Islamic financing schemes that can be advanced and adapted from microfinance purposes including techniques to mitigate the inherent risks. Finally, the paper concludes with the proposals to accommodate the Islamic microfinance within the present Islamic banking structure.

2. Principles of Microfinance

Microfinance grew out of experiments in Latin America and South Asia, but the best known start was in Bangladesh in 1976, following the wide-spread famine in 1974. Advocates argue that the microfinance movement has helped to reduce poverty, improved schooling levels, and generated or expanded millions of small businesses. The idea of microfinance has now spread globally, with replications in Africa, Latin America, Asia, and Eastern Europe, as well as richer economies like Norway, the United States, and England.

Among the features of microfinance is disbursement of small size loan to the recipients that are normally micro entrepreneurs and the poor. The loan is given for the purpose of new income generating project or business expansion. The terms and conditions of the loan are normally easy to understand and flexible. It is provided for short term financing and repayments can be made on a weekly or longer basis. The procedures and processes of loan disbursements are normally fast and easy. Additional capital can also be given after the full settlement of the previous loan.

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Microfinance is an alternative for micro entrepreneurs, which are normally not eligible or bankable to receive loans from commercial banks.

The basic principle of microfinance as succinctly expounded by Dr. Muhamad Yunus, the founder of Grameen Bank Bangladesh, and the recipient of the Nobel Peace Prize in 2006, that credit is a fundamental human right. The primary mission of microfinance is, therefore to help poor people in assisting themselves to become economically independent. Credit or loan is given for self employment and for financing additional income generating activities. The assumption of the Grameen model is that the expertise of the poor are under utilized. In addition, it is also believed that charity will not be effective in eradicating poverty as it will lead to dependency and lack of initiative among the poor. In the case of Grameen Bank of Bangladesh, women comprised of 95% of the borrowers, and they are more reliable than men in terms of repayments [Gibbons and Kassim 1990].

In order to facilitate loan process for the poor, loan is given without collateral or guarantor, and normally is based on trust. Microfinance is an alternative for loan because the conventional banking system recognized the poor as not-credit worthy. Loan facility is provided based on the belief that “people should not go to the bank but bank should go to the people”. In order to obtain the loan, the prospect borrower needs to join the recipient group of microfinance. The group members are given small loans, and the new loans will be given after the previous loans are repaid. The repayment scheme is on short term basis on a scale of a week or every two weeks. The loans are also given together compulsory saving package (e.g. compulsory saving in the group fund) or voluntary saving. The loan priority is for establishing social capital through group joint projects established among the loan recipients.

The loan contract of a Grameen model has a twist, and this is what has most interested academic economists [De Aghion and Morduch 2005]. The twist is that should a borrower be unable to repay her loan (about 95% of borrowers are women), she will have to quit her membership of the bank – as will her fellow group members. While the others are not forced explicitly to repay for the potential defaulter, they have clear incentives to do so if they wish to continue obtaining future loans. This helps micro-lenders overcome “adverse selection” problem. The problem is that a traditional bank has a difficult time distinguishing between inherently “risky” and “safe” borrowers in its pool of loan applicants; if it could, the bank would charge the same (high) rates to all potential borrowers. The outcome of traditional lending activities is inefficient since, in an ideal world, projects undertaken by both risky and safe borrowers should be financed. Therefore, the advantage of the group lending methodology is that it can put local information to work for the outside lender. Adverse selection is mitigated as villagers (safe and risky) know each others’ types. From the standpoint of the micro-lender, bringing the safe borrowers back into the market lowers the average incidence of default and thus lowers costs. With lower costs, the micro-lenders can in turn reduce interest rates even further.

Another strand of argument in support for group lending methodology is that it can potentially mitigate *ex ante* moral hazard problems. Moral hazard problems arise from the fact that financial institution cannot effectively monitor borrowers and therefore cannot write a credible contract that

enforces prudent behaviour. Stiglitz [1990] explains that under group lending methodology, group members agree to shoulder a monetary penalty in the case of default by a peer, the group members have incentives to monitor each other, and can potentially threaten to impose “social sanctions” when risky projects are chosen. Because neighbours can monitor each other more effectively than a bank and thus the effective delegation takes place for *ex ante* monitoring from micro-lender to borrowers.

Another potential benefit of group lending is it reduced *ex post* moral hazard problem. Moral hazard problems arise as it is assumed that the financial institution cannot observe such returns and thus borrowers have incentives to pretend that their returns are low or default on their debt obligations. Group lending with joint responsibility as prescribed by the Grameen model can however lower the incidence of strategic default when project returns can be observed by the borrowers’ neighbours, under the fear of suffering from social sanctions, borrowers will declare their true return and repay their debt obligation [De Maghion and Murdoch 2005]. By lowering the incidence of strategic default, group lending can potentially bring interest rates down as well.

3. Islamic Banking and Microfinance: A Nexus

Islamic finance is founded on the prohibition of *riba*’. *Riba*’ was prohibited in all forms and intentions[1]. Thus, the main aim of Islamic finance and banking is to provide the Muslim society with an Islamic alternative to the conventional banking system that was based on *riba*’ [Ziauddin 1991]. *Riba*’ can be classified into at least two main types, namely credit *riba*’ (*riba*’ *al-nasi’ah*) and surplus *riba*’ (*riba*’ *al-fadl*) [Az-Zuhayli 2006]. Credit *riba*’ is any delay in settlement of a due debt, regardless whether the debt of goods sold or loan. Muslim jurists define *riba*’ *al-nasi’ah* in loans as bringing to the lender a fixed increment after an interval of time, or extension of time over the fixed period and increase of credit over the principal. On the other hand, surplus *riba*’ (*riba*’ *al-fadl*) is the sale of similar items with a disparity in amount in the six canonically-forbidden categories of goods: gold, silver, wheat, barley, salt, and dry dates. This *riba*’ is by way of excess over and above the quantity of the commodity advanced by the lender to the borrower. *Riba*’ also exists if there is either inequality or delay in delivery of the goods offered.

As explained by Qureshi [1991], Imam Fakhruddin Razi in his book *al-Tafsir al-Kabir* emphasizes that there are basically 3 reasons for the unlawfulness of *riba’*. The first reason is where the creditor’s can ensure its income from the interest paid by the debtor that will lead to the exploitation and living in reduced circumstances which is a massive inequity. Charging excess or surplus in exchanging one commodity against the other will lead to the exploitation of the borrowers. The borrowers would have to pay back the interest on top of the principal. This will make the lenders better off at the expense of the borrowers. In addition, the strong condemnation of interest based transactions is intended to uphold equity and the protection of the poor (i.e. the borrower). In other words, interest or *riba*’ supports the possibility for wealth to accumulate in the

1) The revelation on the prohibition of *riba’* in the *Qur’an* can be classified into 4 stages; the first stage was on the moral denunciation of *riba’* in *al-Rum* verse 39, the second stage was on comparing *riba’* with the Jews in *al-Nisa’* verse 61, the third stage was on the legal prohibition in *al-Imran* verse 130-132 and finally, the fourth stage was on *al-bay’* (trading) as the alternative to *riba’* in *al-Baqarah* verse 275-281.

hands of a few, and thereby it shows that man's concern for his fellow men is decreased.

Secondly, since interest or *riba*' is predetermined and the creditor is certain to receive the interest imposed, it may prevent the creditor from being involved in any occupation because it is certainly easy to receive income from the interest on a loan [Qureshi 1991]. In this situation, the creditor has not made any effort or undergone any hardship in acquiring income and this will hinder the progression of worldly affairs. Finally the unlawfulness of *riba*' is due to an end of mutual sympathy, human goodliness and obligations because the practice of *riba*' may lead to borrowing and squandering [Qureshi 1991].

As an alternative to *riba*', the profit and loss sharing arrangements are held as an ideal mode of financing in Islamic finance. It is expected that this profit and loss sharing will be able to significantly remove the inequitable distribution of income and wealth and is likely to control inflation to some extent [Siddiqui 2001]. Furthermore, the profit and loss sharing may lead to a more efficient and optimal allocation of resources as compared to the interest-based system. Since the depositors are likely to get higher returns leading to richness, it is hoped that progress towards self-reliance will be made through an improved rate of savings. Thus will ensure justice between the parties involved as the return to the bank on finance is dependent on the operational results of the entrepreneur [Siddiqui 2001].

Consequently, the theory of Islamic finance gives rise to the development of Islamic banking where the functions of a bank do not vary between conventional and Islamic banks. However, the operations, philosophy, and objectives differ significantly between the conventional and Islamic Banks [Ziauddin 1991]. Conventional bank operates its business in the capitalist system where the root of the system is based on interest and *riba'*. On the other hand, the Islamic bank provides the solution to the Muslims in terms of principles, instruments and issues in dealing with banking business activities where the operations of the activities are based on the principles of the *Shari'ah*.

From early 1960s, the existence of Islamic banks has been in a consistent phase. In 1963, the Mit Ghamr Saving Bank was founded. It is a small rural institution in Egypt. Later in 1971, the Mit Ghamr Saving Bank was incorporated into a new government controlled institution, the Nasser Social Bank. A major expansion in Islamic banking activities started to take place in the 1970s. The expansion of Islamic banks is partly due to the oil revenue boom in the Gulf and the growing economic muscle of the more conservative Muslim states of the Gulf [Wilson 2000]. In 1970s, a number of Islamic banks were established including the initiative of the Organization of Islamic Countries (OIC) that established the Islamic Development Bank (IDB). During the same period, Dubai Islamic Bank, Faisal Islamic Bank in Egypt, Kuwait Finance House, and Jordan Islamic Bank were established. In 1978, the Islamic Banking System International Holding was established in Luxembourg. This was the first Islamic financial institution on the Western soil. The rapid development of Islamic banking worldwide portrays that the expansion of Islamic banking was not only confined to the Middle East but it has also grabbed the attention of its international counterparts.

The expansion of Islamic banks continued in the 1980s, where Dar al-Mal al-Islami was established in Switzerland, and the Islamic Bank International was established in Denmark. In

1983, Bank Islam Malaysia Berhad was established in Malaysia and followed by Qatar Islamic Bank. In 1990s, the Indonesian government took the initiative to establish Bank Muamalat Indonesia, an Islamic bank that started operations in 1992.

Due to the massive expansion in Islamic banking activities, some commercial banks started offering Islamic banking facilities (e.g. state-owned banks in Egypt, National Commercial Bank in Saudi Arabia). Furthermore, the Islamic financial product is also now offered by the European banks (i.e. Kleinwort Benson of London and the Swiss Banking Corporation). Such developments show that the Islamic financial instruments are increasingly being accepted internationally, even in the non-Islamic countries, and the basic principles are understood [Wilson 2000].

At the moment, there are about 270 Islamic banks worldwide with a market capitalization in excess of US$13 billion. The assets of Islamic banks worldwide are estimated at more than US$265 billion and financial investments are above US$400 billion. Islamic bank deposits are estimated at over US$202 billion worldwide with an average growth of between 10 and 20%. Furthermore, Islamic bonds are currently estimated at around US$30 billion and are the ‘hot issue’ in Islamic finance. In addition, Islamic equity funds are estimated at more than US$3.3 billion worldwide with a growth of more than 25% over seven years and the global Takaful premium is estimated at around US$2 billion.

In looking at the principles of Islamic finance, one can easily observe that the early “idealistic” vision has significantly changed in practice. Idealist, liberal and pragmatic approaches to Islamic banking and finance can be identified in a continuum [Saeed 2004]. The idealist approach seeks to maintain the relevant contracts that were developed in the *shari’ah* in the classical period. At the opposite end of the continuum are those scholars who argue that the term *riba*’ does not include modern bank interest. Between these two extremes lies the pragmatic approach, which is realistic enough to see that the idealist model of Islamic banking has significant problems in terms of feasibility and practicality, but which at the same time maintains the interpretation of *riba*’ as interest. It can be added to this continuum, an alternative idealist approach that blends the pragmatic approach and socially responsible financing where Islamic banks offer Islamic financial instruments for microfinance purposes.

Despite the wide acceptance of Islamic banking worldwide, the concept of financing for the poor or microfinance by Islamic banks was not well developed. Most Islamic banks, as in the case of conventional commercial banks, did not provide easy access to financing to the poor. A further pragmatic shift in Islamic banking and finance is the almost complete move from supposedly Profit and Loss Sharing (PLS) banking to sales-based system [Saeed 2004]. The literature of the 1960s and 1970s was clear that Islamic banking and finance should based on PLS. Apart from the relationship between the bank and the depositor, in which a form of PLS that is based on *mudarabah* is institutionalized, Islamic banks in the vast majority now avoid PLS as the most important basis for their investment activities. Instead, such activities operate largely on the basis of contracts that are considered “mark-up” based such as *murabahah*, *salam*, *ijarah* or *istisna*’. For the bulk of their investment operations, Islamic banks have opted for these mark-up based, relatively safe contracts, which are similar, in some respects to lending on the basis of fixed interest. Simultaneously, the use

of less secure and more risky contracts such as *mudarabah* and *musharakah* has been dramatically reduced to only a small share of assets on the investment side.

Historically, Prophet Muhammad was among the poor and later became a successful trader for many years before he became a prophet. This was mainly due to the microfinance capital for his ventures that was provided on a PLS based on *mudarabah* by a wealthy widow, Khadijah, who later became his wife. Trade, with its associated risks, was fundamental to the economy of Arabia, since communities tended not to be self-sufficient and they depended on the movement of goods over large distances, in difficult and dangerous terrain, which required substantial risk capital. The *Qur'an* indeed commends trade (Al-Baqarah, verse 198), and defines the poor (Al-Baqarah, verse 273) as those that need alms.

Many elements of microfinance could be considered consistent with the broader goals of Islamic banking. Both systems advocate entrepreneurship and risk sharing and believe the poor should take part in such activities [Dhumale and Sapcanin 1999]. At a very basic level, the disbursement of collateral-free loans in certain instances is an example of how Islamic banking and microfinance share common aims. This close relationship would not only provide obvious benefits for poor entrepreneurs who would otherwise be left out of credit markets, but investing in micro-enterprises would also give investors in Islamic banks an opportunity to diversify their investments.

In support of providing access to Islamic financing to the poor and small entrepreneurs, Chapra [1992: 260-261] has succinctly argued that: "Lack of access of the poor to finance is undoubtedly the most crucial factor in failing to bring about a broad-based ownership of businesses and industries, and thereby realizing the egalitarian objectives of Islam. Unless effective measures are taken to remove this drawback, a better and widespread educational system will only help raise efficiency and incomes but ineffective in reducing substantially the inequalities of wealth. This would render meaningless the talk of creating and egalitarian Islamic society. Fortunately, Islam has a clear advantage over both capitalism and socialism which is built into its value system and which provides biting power to its objective of socio-economic justice."

Chapra [1992: 269] further emphasized that: "While there may be nothing basically wrong in large enterprises if they are more efficient and do not lead to concentration of wealth and power. It seems that the adoption of a policy of discouraging large enterprises except when they are inevitable, and of encouraging SMEs, as much as possible, would be more conducive to the realization of the *Maqasid Al-Shari'ah* (Goals of Islamic Law). This would have a number of advantages besides that of reducing concentration of wealth and power. It would be more conducive to social health because ownership of business tends to increase the owners' sense of independence, dignity and self-respect."

4. Princeples of Islamic Microfinance

The Grameen Bank is an outstanding example of a successful microfinance institution. The award of the Nobel Prize in 2006 to the founder of the Grameen Bank, Muhammad Yunus, brought microfinance to international attention. Although Bangladesh is a predominantly Muslim country, the Grameen Bank is not a *shari'ah* compliant financial institution as it charges interest on loans,

and pays interest to depositors. Even though Grameen Bank calculates its rates of interest in simple rather than in compounded terms, it does not mitigate the *riba'* transactions [Wilson 2007].

There are also wider concerns with conventional microfinance from a Muslim perspective. Although the provision of alternatives to exploitative lending is applauded, there is issue of whether these are sustainable if they conflict with the values and beliefs of local Muslim communities. As interestingly pointed by Wilson [2007], simply extending materialism and consumerism into rural poor communities and urban shanty town settlements could actually undermine social cohesion, by raising false expectations which could not be fulfilled, resulting in long term frustration and possible discontent or even economic crime. Supporters of Islamic alternatives to conventional microfinance have as their aim the enhancement of Islamic society, rather than with the promotion of values that might be contrary to *shari'ah*. Comprehensive Islamic microfinance should involve not only credit through debt finance, but the provision of equity financing via *mudarabah* and *musharakah*, savings schemes via *wadiah* and *mudarabah* deposits, money transfers such as through *zakat* and *sadaqah*, and insurance via *takaful* concept.

Table 1 summarizes the possible differences in characteristics and objectives between the conventional microfinance and Islamic microfinance.

Items	**Conventional MFI**	**Islamic MFI**
Liabilities (Source of Fund)	External Funds, Saving of Client	External Funds, Saving of Clients, Islamic Charitable Sources
Asset (Mode of Financing)	Interest-Based	Islamic Financial Instrument
Financing the Poorest	Poorest are left out	Poorest can be included by integrating with microfinance
Funds Transfer	Cash Given	Goods Transferred
Deduction at Inception of Contract	Part of the Funds Deducted as Inception	No deduction at inception
Target Group	Women	Family
Objective of Targeting Women	Empowerment of Women	Ease of Availability
Liability of the Loan (Which given to Women)	Recipient	Recipient and Spouse
Work Incentive of Employees	Monetary	Monetary and Religious
Dealing with Default	Group/Center pressure and threat	Group/Center/Spouse Guarantee, and Islamic Ethic
Social Development Program	Secular (non Islamic) behavioral, ethical, and social development	Religious (includes behavior, ethics and social)

Table 1: Differences between Conventional and Islamic Microfinance (Source: [Ahmed 2002]

Ahmed [2002] noted several distinctions that distinguish conventional microfinance from Islamic Microfinance. Both conventional microfinance and Islamic Microfinance can mobilize

external funds and saving of clients as their source of fund. However, Islamic microfinance can also exploit Islamic charity such as *zakat* [2], and *waqf* [3] as their source of fund for funding. For modes of financing, conventional microfinance can easily adapt interest-based financing while Islamic microfinance should eliminate interest in their operation. Therefore, Islamic microfinance should explore possible modes of Islamic financing as instruments in their operation.

Islamic microfinance can also maximize social services by using *zakat* to fulfill the basic needs and increase the participation of the poor. In conventional microfinance, the institution can directly give cash to their client as the financing. In contrast, Islamic microfinance does not give cash to their client as loan is not allowed in Islam unless there is no interest or any incremental amount charge on that loan.

Conventional microfinance had also been questioned on its overall desired impact since the poor are subjected very high interest rate some up to 30%. Some even argued that disbursing credit to the poor to make financial gains out of the same cannot be the aim of microfinance institutions. Interest charged is rather oppressive for their poor receivers, and thus fails to achieve the noble objective of microfinance. According to various studies, a notable number of the recipients were also found to be well above the poor category.

Islamic microfinance, on the other hand, utilises Islamic financial instruments which are based on PLS schemes rather than loan. Conventional microfinance institutions focused mainly on women as their client. On the other hand, Islamic microfinance institution should not only focus on women but must also be extended to the family as a whole. Moreover, conventional microfinance used group lending as a way to mitigate risk in their operation. Islamic microfinance may also use similar technique, but they can also developed Islamic ethical principles to ensure their client pays the payment regularly.

There are a number of *shari'ah* compliant microfinance schemes, notably those operated by Hodeibah microfinance program in Yemen, the UNDP *Murabahah* based microfinance initiatives at Jabal al-Hoss in Syria, *Qardhul Hasan* based microfinance scheme offered by Yayasan Tekun in Malaysia, various schemes offered by Bank Rakyat Indonesia, and Bank Islam Bangladesh. Many argued that Islamic microfinance is best provided by non-banking institutions. Some others argued that with *mudarabah* and *musharakah* profit sharing microfinance there is scope for commercial undertakings, but arguably specialized finance companies rather than banks, even Islamic banks, may be appropriate institutions to get involved [Wilson 2007]. However, this paper explores further and extends the argument for Islamic microfinance schemes to be offered by Islamic commercial

2) *Zakat* is the third of the five basic pillars of Islamic faith. *Zakat* is a levy normally at the rate of 2.5% charged on certain types of wealth such as business wealth, personal income etc. Only the Muslims who own the wealth beyond the minimum limit are charged *zakat*. In a way, it is a compulsory levy imposed on the Muslims so as to take surplus money or wealth from the comparatively well-to do members of the Muslim society and give it to the destitute and needy. In Islam, all resources belong to God and the wealth is held by human beings only in trust. *Zakat* is also a part of a social system of Islam as the poor has certain rights in the wealth of the rich. Thus, *zakat* acts as a mechanism for the distribution of wealth, which helps closing the gap between the poor and the rich.

3) The word *waqf* in Arabic literally means "confinement and prohibition" or causing a thing to stop and stand still. In Islamic legal terminology, *waqf* is defined as protecting an asset in order to refrain the usage, and will be utilized and benefited for the purpose of charity.

banks. The preceding sections will discuss these possibilities.

5. Islamic Microfinance Instruments and Risks Mitigation

The paper argues that Islamic banking needs to consider Islamic microfinance instruments in addition to normal retail and trade financing instruments currently on offer. The imbalances of focusing too much on low risk *murabahah* types of instruments at the expense of profit and loss sharing instruments based on *mudarabah* and *musharakah* are long standing criticisms for Islamic banking can be mitigated by focusing certain portion of financing activities for microfinance. Understandably, Islamic banks mostly are profit ventures, thus, by providing a portion of financing for the poor will shift the focus to encompass socially responsible financing.

Islamic banking, with its emphasis on risk sharing and, for certain instruments, collateral free loans, is compatible with the needs of some micro-entrepreneurs. And because it promotes entrepreneurship, expanding Islamic banking to the poor could foster development under the right application [Dhumale and Sapcanin 1999]. The following principles have great potentials to be advanced and adapted as Islamic microfinance schemes:

5.1 *Mudarabah*

Mudarabah has the potential to be adapted as Islamic microfinance scheme. *Mudarabah* is where the capital provider or microfinance institution (*rabbul mal*) and the small entrepreneur (*mudarib*) become a partner. The profits from the project are shared between capital provider and entrepreneur, but the financial loss will be borne entirely by the capital provider. This is due to the premise that a *mudarib* invests the *mudarabah* capital on a trust basis; hence it is not liable for losses except in cases of misconduct. Negligence and breach of the terms of *mudarabah* contract, the *mudarib* becomes liable for the amount of capital.

Mudarabah structure could be based on a simple or bilateral arrangement where Islamic bank provides capital and the micro-entrepreneur acts as an entrepreneur.

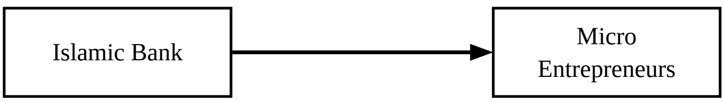


Figure 1: Simple *Mudarabah*

Mudarabah structure may also be based on two-tier structure or *re-mudarabah* where 3 parties i.e. capital provider (public, government, *zakat*, *waqf* etc.), intermediate *mudarib* (Islamic Bank) and final *mudarib* (micro entrepreneur).



Figure 2: *Re-Mudarabah*

The profit-sharing ratio on *mudarabah* is pre-determined only as a percentage of the business profit and not a lump sum payment. The profit allocation ratio must be clearly stated and must be on the basis of an agreed percentage. Profit can only be claimed when the *mudarabah* operations make a profit. Any losses must be compensated by profits of future operations. After full settlement has been made, the business entity will be owned by the entrepreneur. The entrepreneur will exercise full control over the business without interference from the Islamic bank but of course with monitoring. On the practical side, there is a problem to determine the actual total profit to be shared because micro entrepreneurs normally do not have proper accounts or financial statement [Dhumale and Sapcanin 1999].

Meanwhile, *muzara'ah* is a form of *mudarabah* contract in farming where Islamic bank can provide land or monetary capital for farming product in return for a share of the harvest according to the agreed profit sharing ratio. In the context of microfinance, the capital provider may need huge capital and expertise to manage such initiative and may need to manage higher risk because the Islamic bank need to involve directly in the farming sector through provision of asset such as land.

In the case of *mudarabah*, the Islamic bank may face capital impairment risk as loss making operations of micro entrepreneurs expose the Islamic bank to the risk of capital erosion. In addition, since in *mudarabah* the Islamic bank should not request collateral may expose Islamic bank to credit risk on these transactions. As part of risk mitigation, even though the entrepreneur exercises full control, Islamic bank can still undertake supervision [Iqbal and Mirakhor 1987].

5.2 *Musharakah*

Musharakah can also be developed as a micro finance scheme where Islamic bank will enter into a partnership with micro entrepreneurs. If there is profit, it will be shared based on pre-agreed ratio, and if there is loss, it will then be shared according to capital contribution ratio. The most suitable technique of *musharakah* for microfinance could be the concept diminishing partnership or *musharakah mutanaqisah*.

A: (Islamic Bank 80%) B: (Micro Entrepreneur 20%)

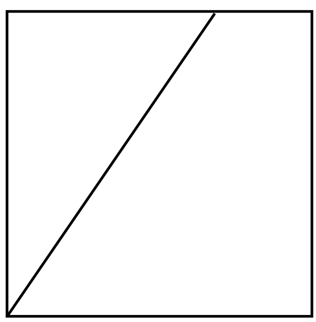


Figure 3: *Musaharakah Mutanaqisah*

The above diagram shows that in the case of *musharakah mutanaqisah*, capital is not permanent and every repayment of capital by the entrepreneur will diminish the total capital

ratio for the capital provider. This will increase the total capital ratio for the entrepreneur until the entrepreneur becomes the sole proprietor for the business. The repayment period is dependent upon the pre-agreed period. This scheme is more suitable for the existing business that need new or additional capital for expansion.

Another form of *musharakah* is *musaqat*. *Musaqat* is a profit and loss sharing partnership contract for orchards. In this case, the harvest will be shared among all the equity partners (including entrepreneur as a partner) according to the capital contributions. All the *musharakah* principles will be applicable for this form of *musharakah*. This scheme, however, could be of high risk, since it needs the capital and expertise to directly involve in the business especially in managing the orchards.

Musharakah capital may also be subjected to capital impairment risk, where the capital may not be recovered, as it ranks lower than debt instruments upon liquidation [Haron and Hock 2007]. The normal risk mitigation techniques that can be adopted by Islamic banks are also applicable in the case of microfinance i.e. through a third-party guarantee. This guarantee can be obtained and structured for the loss of capital of some or all partners through the active role of the so called Credit Guarantee Corporation (CGC) as practiced in the case of SME financing in Malaysia.

5.3 *Murabahah*

Using *murabahah* as a mode of microfinance requires Islamic bank to acquire and purchase asset or business equipment then sells the asset to entrepreneur at mark-up. Repayments of the selling price will be paid on installment basis. The Islamic bank will become the owner of the asset until the full settlement. This scheme is the most appropriate scheme for purchasing business equipment. This mode of financing has already been introduced in Yemen in 1997. In 1999, there are more than 1000 active borrowers [Dhumale and Sapcanin 1999]. Borrowers must form a group of 5 micro entrepreneurs where all members will act as guarantor if there is default among their group members. The benefit of this mode of financing is continuous monitoring, and entrepreneurs with a good reputation of repayment will be offered extra loan.

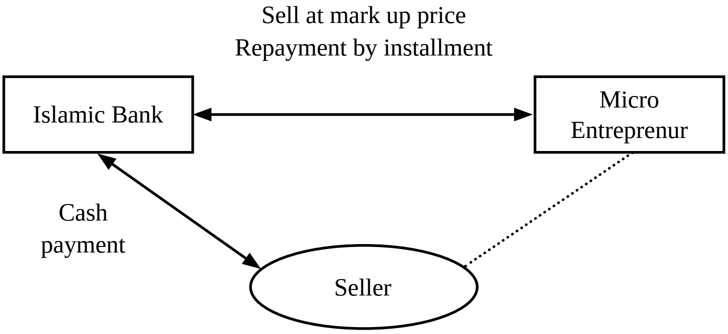


Figure 4: *Murabahah* to the Purchase Orderer

Dhumale and Sapcanin [1999] in their study on the feasibility of Islamic microfinance funded by the World Bank, has evaluated Islamic financing schemes namely *murabahah*, *mudarabah* and *qardhul hasan* as potential schemes to be advanced for Islamic micro finance. *Murabahah* has been

found to be more practical and most suitable scheme for Islamic microfinance to be provided by Islamic banks. This is due to the fact that the buy-resell model which allows repayments in equal installment is easier to administer and monitor.

The above diagram indicates the application of the extended concept of *murabahah* i.e. *Murabahah* to the Purchase Orderer. This is where a micro-entrepreneur enters into a sale and purchase agreement, or memorandum of understanding to purchase a specific kind of goods or equipments needed by the micro-entrepreneur with the Islamic bank. The Islamic bank then sells the goods to the entrepreneur at cost plus mark-up, and entrepreneur can pay back later in lump-sum or by installments (*bai muajal*). A number of *shari'ah* principles must be met for the contract to be valid [Haron and Hock 2007], such as the goods must in existence at the time of sale; ownership of the goods must be with the bank; the goods must have the commercial value; the goods are not be used for a "*haram*" purpose; the goods must be specifically identified and known; the delivery of goods is certain and not conditional upon certain other events; and, the selling price is fixed at cost plus mark up

Murabahah could be easily implemented for microfinance purposes and can be further exemplified by the used of deferred payment sale (*bai' al-muajal*). *Murabahah*, however, may expose Islamic bank as in the case conventional lending to credit risk. This, however, can be mitigated by requesting for an *urboun*, a third party financial guarantee, or pledge of assets. In addition, Islamic bank can also institutes direct debit from the entrepreneur's account, centralizes blacklisting system, and minimum non-compounded penalty to deter delinquent entrepreneurs. *Murabahah* to the Purchase Orderer also exposes Islamic banks to delivery risk where goods are not delivered, goods not delivered on time, or goods delivered not according to specification by the entrepreneur after payment is made by the Islamic bank. To mitigate delivery risks, Islamic bank may request a performance guarantee from the seller to give assurance on the delivery of goods [Haron and Hock 2007].

5.4 *Ijarah*

Ijarah by definition is a long term contract of rental subject to specified conditions as prescribed by the *shari'ah*. Unlike conventional finance lease, the lessor (Islamic bank) not only owned the asset but takes the responsibility of monitoring the used of asset and discharges its responsibility to maintain and repair the asset in case of mechanical default that are not due to wear and tear. The bank should first purchase the asset prior to execution of an *ijarah* contract. The bank takes possession of the assets and subsequently offers the asset for lease to customer. The bank then is responsible for the risks associated with the asset.

Ijarah Muntahia Bitamleek is an elaborate concept of *ijarah* where the transfer of ownership will take place at the end of the contract and pre-agreed between the lessor and the lessee. The title of the asset will be transferred to the lessee either by way of gift, token price, pre-determined price at the beginning of the contract or through gradual transfer of ownership. *Ijarah Muntahia Bitamleek* is more suitable for micro finance scheme especially for micro entrepreneurs who are in need of assets or equipments. Islamic bank will purchase the assets required by the entrepreneurs

and rent the assets to qualified entrepreneurs. In this case, the entrepreneurs can just rent the asset over a period of time and pay the rentals at regular intervals. The entrepreneur as a lessee will be responsible to safeguard the asset whereas the lessor will monitor their usage.

For *ijarah*, the Islamic bank may be exposed to settlement risk where the entrepreneur as a lessee is unable to service the rental as and when it falls due. Similarly, the Islamic bank can request an *urboun* from the entrepreneur which can also be taken as an advance payment of the lease rental. Alternatively, the Islamic bank as the owner of the asset should has the right to repossess the asset [Haron and Hock 2007].

5.5 *Qardhul Hasan*

Another simple concept that can be advanced for microfinance purposes is *qardhul hasan* or simply means an interest free loan. Islamic bank can provide this scheme to the entrepreneurs who are in need of small start-up capital and have no business experience. The Islamic bank then will only be allowed to charge a service fee. The term of repayment will be on installment basis for an agreed period. The scheme is also relevant for micro entrepreneurs who are in need of immediate cash and has good potential to make full settlement. Here, the Islamic bank will bear the credit risk and they need to choose the right technique to ensure repayments will be received as agreed.

6. Islamic Microfinance and Islamic Banking

Commercial banks, however, were initially excluded from the domain of microfinance (rather, banks did not want to get involved in it) which for some time was the exclusive domain of specialized institutions normally NGOs. NGOs, due to their knowledge and familiarity with local clientele in less developed countries, have played a fundamental role as intermediaries in managing funds for microfinancing [Ferro 2005]. Concerns about the lack of real profitability of microfinance prevented banks from getting involved in microfinance. The inherent risks posed by microfinance and the widespread belief that the poor are poor because of their lack of skills, keeping traditional banks including Islamic banks away from microfinance.

The paper argues that Islam has the potential to provide various schemes and instruments that can be advanced and adapted for the purpose of microfinance in Islamic banks. Comparatively, *qardhul hasan*, *murabahah* and *ijarah* schemes are relatively easy to manage and will ensure the capital needs (*qardhul hasan*), equipments (*murabahah*) and leased equipments (*ijarah*) for potential micro entrepreneurs and the poor. Participatory schemes such as *mudarabah* and *musharakah*, on the other hand, have great potentials for microfinance purposes as these schemes can satisfy the risk sharing needs of the micro entrepreneurs. These schemes, however, require specialized skills in managing risks inherent in the structure of the contract. In theory, different schemes can be used for different purposes depending on the risk profile of the micro entrepreneurs.

Based on the above cursory discussion, it is apparent that inherent risks attached to Islamic modes of financing will expose Islamic banks. However, there are various risks mitigation techniques available, as indicated in the previous section, that are not only unique to microfinance as long as the techniques are *shari'ah* compliant. The main contention that micro-entrepreneurs are

among the poor, and the poor are not credit worthy or bankable, needs to be seriously examined. Received wisdom that lending to poor households is doomed to failure: costs are too high, risks are too great, savings propensities are too low, and few households have much to put in terms of collateral [Murdoch 1999].

Islamic banks definitely need to learn from the success of conventional microfinance in particular the Grameen Bank. As expounded by Muhammad Yunus credit is a fundamental human right where every person must be allowed a fair chance to improve his/her economic conditions. Credit has the capacity to create self-employment, thereby increasing their income, and they can use this additional income to satisfy the other basic human rights for food, shelter, health and education [Gibbons and Kassim 1990]. As argued by Murdoch [1999] perhaps the group lending methodology as adopted by Grameen bank as the key to their success. The common idea of group lending to low-income households should have immediate appeal to Islamic banking theorists and Islamic bankers, as a vision of building programs around households "social" assets even when physical assets are few. Group lending is not the only mechanism that differentiates microfinance from conventional lending. Most of the successful microfinance institutions such as Grameen, Banco Sol (Bolivia) and Bank Rakyat Indonesia, adopted dynamic incentives, regular repayment schedules (e.g. weekly basis), and collateral substitutes to help maintain high repayment rates should be learned and adapted by Islamic banks.

If Islamic banks consider giving financing to the poor is risky business despite the various risk mitigation techniques available, then the proposal made by Wilson [2007] for microfinance institution to adopt and adapt the *wakalah* model as widely used in Islamic *takaful* insurance, should be seriously considered. Even though Wilson [2007] did not propose the model to be adopted by an Islamic bank specifically, it is worthy to examine the model. Under this *wakalah* model, microfinance institution will act as an agent whereby microfinance fund could be provided from *zakat* fund or NGO donor agency. The microfinance institution will be paid management fee for their work in managing the fund. The micro-entrepreneur, as participants, will be disbursed the fund by the microfinance institution, and repay the fund by installments with the element of tabarru (donation).

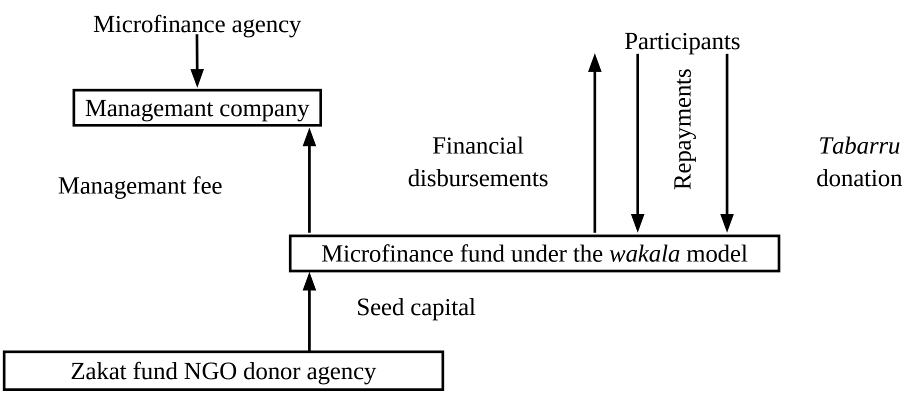


Figure 5: *Wakalah* Model for Microfinance [Wilson 2007]

According to Wilson [2007], an advantage of the *wakalah* model is that it combines some of the features of a credit union with professional financial management, but ensures the interests of the participants by the management as there is a potential for a conflict of interest, with participants losing out if management remuneration is excessive and not transparent. Hence, with the *wakalah* model, the management is remunerated by a fixed fee, and they do not share in the *wakalah* fund, the sole beneficiaries from which are the participants. The latter make a donation to the fund, which can be regarded as a *tabarru*, a term implies solidarity and stewardship.

The paper argues that the *wakalah* model can still be adopted by the Islamic bank. Here, rather than the fund is coming from shareholders and depositors, it will be contributed by the government or *zakat* fund, and it will consequently reduce the inherent risks of the Islamic bank. As with credit union, participants are entitled to draw disbursements from the fund, which can exceed their contributions at any given date. Obviously not all participants can withdraw funds in excess of their contributions at the same time as there would be insufficient funds to meet the demand. This implies a rationing mechanism is necessary. With the *tabarru*' principle, the motivation is not a price incentive such as interest payment, but rather to help participants among the micro-entrepreneurs and the poor meet their financial requirements while at the same time building up entitlements to similar help [Wilson 2007].

7. Conclusions

The paper reviews the concepts of microfinance, and argues that the main objectives of microfinance schemes to alleviate poverty and to enable the poor to empower themselves are in line with the Islamic economic principles of justice. However, the conventional microfinance schemes and operations based on interest (*riba*') are prohibited in Islam and thus, cannot be used by and for the Muslims. Hence, various Islamic financing schemes based on the concepts of *mudarabah*, *musharakah*, *murabahah*, *ijarah* etc. have the salient features and characteristics that can contribute towards a more ethical economic and financial development of the poor and micro entrepreneurs. Since Islamic banking has not addressed the needs of financing among the poor and micro entrepreneurs, Islamic microfinance is argued as a missing component in Islamic banking. The paper also argues that there is a nexus between Islamic banking and microfinance as many elements of microfinance could be considered consistent with the broader goals of Islamic banking. Finally, the paper indicates that the *wakalah* model as used by many Islamic *takaful* insurance companies has the potential to become an alternative structure for Islamic banks to offer Islamic microfinance instruments. Further studies are needed to examine the *wakalah* model and other possible structures and governance models so that Islamic banks can effectively offer Islamic microfinance instruments and mitigate its inherent risks.

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